RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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MAY 15, 1985 Letter 913

May 3 DJIA 1247.24; PTI 1732; A-D Ratio -16.82
May 10 DJIA 1274.18; PTI 1760; A-D Ratio -15.90

THE PICTURE: Some people are compounding their money in this era of sky-high real interest rates, and they don't care which way the stock market goes. Some readers are long stocks, and they want this market to go up. Maybe 10% of my subscribers are holding shorts, and they'd love the market to head south.

So far, the scoreboard has basically favored the interest rate collectors and compounders. Here's the record from January 1 to May 1. D-J Industrials up 3.8%, D-J Transports up 2.8%, D-J Utilities up 2.7%, S&P Composite up 7.5%, NYSE Composite up 8.0%. So in general, I would say that profits have been hard to come by in 1985.

If you had bought Treasury bonds on January 1, you would probably have done as well as most stock buyers. You would have three points under your belt here in May with a bit over 5% collected in interest. As for gold, you would be just about even now if you had bought the metal on January 1 -- but you would nevertheless be out 4% in interest (interest you would have collected if you had purchased T-bills instead).

As veteran readers know, I'm a firm believer in studies that reflect the ACTION of the market. Sure, I follow the odd lots and the short interest and the activity of the specialists, and I know what percentage of the advisors are bullish and bearish. But I like the studies which reflect what the market is actually DOING. I like to watch the movement of the major averages, the action of the advances and declines, the number of highs and lows, the volume.

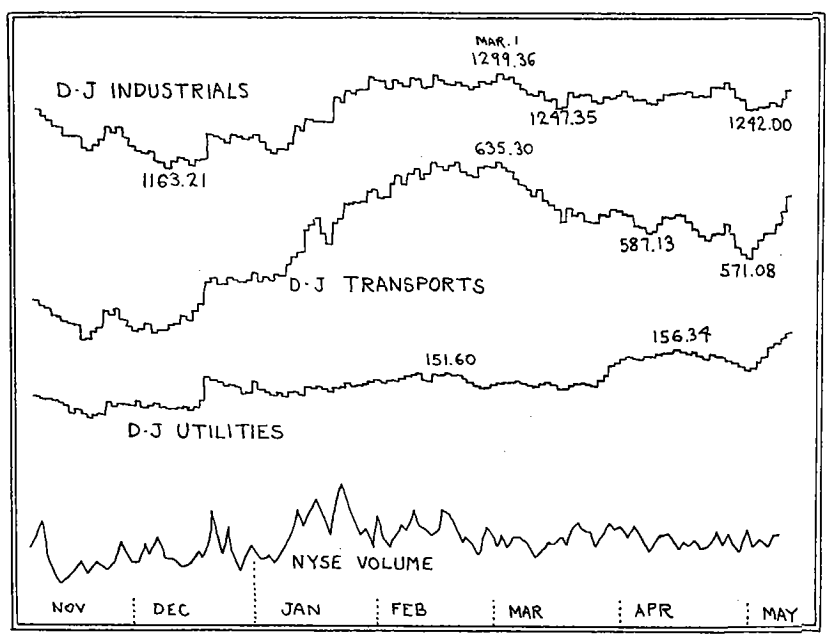
I'm also a believer in the thesis that EVERYTHING is reflected in the price action of the market. And, of course, THE basic study of the price action is the Dow Theory. The classical Theory deals with just two Averages, the D-J Industrials and the D-J Transports. Many students utilize the D-J Utility Average as a further confirmation of the other two. This is OK, but we should remember that the Utilities play no part in classical Dow Theory (perhaps because the Utility Average was first available in 1929, long after the original Dow Theory had been formulated).

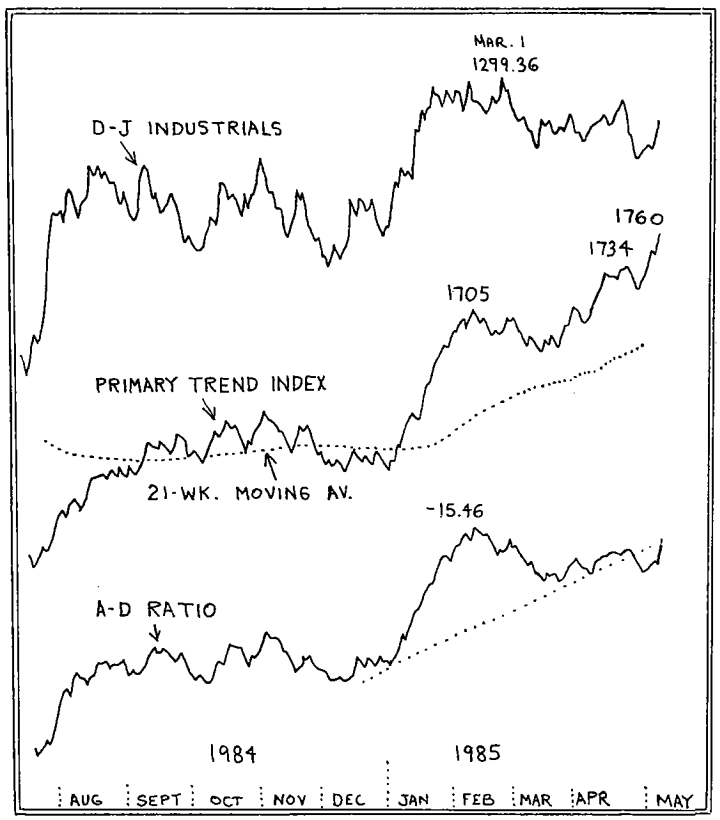
Additional confirmation of the market's trend can be sought from the various widely-followed composites such as the S&P 500, the NYSE Composite and the Value Line composite. If a major trend is in force, then in due time ALL the major composites and indices will confirm that trend. I can't remember ever seeing a primary movement which did not take all the indices with it, maybe not in the same week, but certainly within a matter of a month or so.

Let's move to the present situation in the stock market. What about the recent Dow break below 1247.35? What about those May 1 lows? In a nutshell, the May 1 Dow penetration was one of those fairly rare occurrences when the market tests a level in order to see whether there is any real liquidating pressure. The answer on May 1 was -- no pressure to liquidate, no real urge to sell. Although the D-J Industrials and Transports confirmed each other on the downside, volume dried up with lower prices. On top of that, the A-D ratio (see page 2 chart) refused to confirm the new lows. Both the S&P 500 Composite and the NYSE Composite also refused to confirm the new lows. Finally, my Primary Trend Index (PTI) stubbornly refused to go down.

Then on May 6 the PTI rose to another 1985 high of 1738. Which brings me to a basic rule for reading the PTI. Here's the rule: If the PTI continues to make successive new highs, it is ultimately going to drag the market up with it. The more persistent the series of new PTI highs, the more certain that the stock market will be forced to higher levels.

In the last Letter, I warned that if the Dow broke 1247.35, "I'll be easing towards the exits." Well, the Dow did break 1247.35, but as I explained there was simply no follow-through. For that reason, I stopped at the exit and encouraged by the PTI action I held on to stocks. Yes, the bull is still in the box.





Conclusion: Hopefully, the excellent action of May 9 represents the turning point for this market. On that day everything finally got in gear on the upside, and the PTI again registered a new high. May 9 saw the D-J Transports break above their trading range of the last two months, while the Utility Average rose to another new 19-year high. It remains only for the D-J Industrial Average to provide some real encouragement. The two upside points of importance for the Dow are the April 26 peak of 1284.78 and then the record high of 1299.36 registered on March 1. Back on April 25 the NYSE Composite hit a record high of 106.25 and the S&P 500 hit a record high of 183.43. Obviously, a bettering of those April 25 highs by either (hopefully, both) of these composites would be highly bullish.

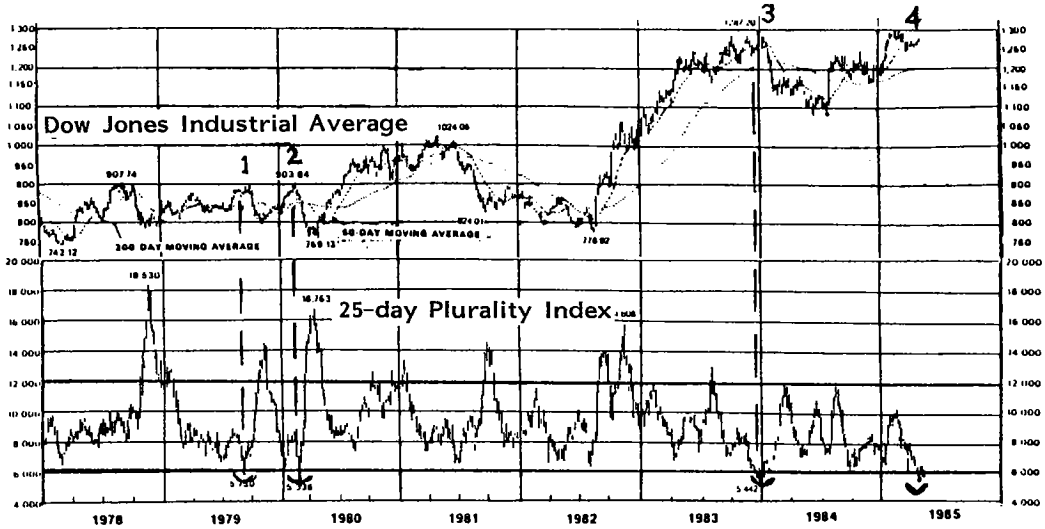
Up to now there's been a lot of churning in this market, and this is documented in the next section. But against that we have the excellent Utility action, the series of new highs in the PTI, the rising trend in both the NYSE debit (margin) and credit accounts (highly bullish), and the stubbornly high short interest on the NYSE (also bullish). The recent spate of odd-lot shorting (the odd lot shorts tend to be wrong when they are most active) is also a big plus. Let's hope that the lethargy is over, and above all that the Dow finally does its stuff on the upside. Remember, the critical Dow points to the north are 1284.78 and 1299.36.

AS THE WORLD CHURNS: The late Paul Dysart developed some of the most basic and important studies having to do with market breadth. Dysart invented the positive and negative volume indices; he also invented the 25-day plurality index. It is the latter that I want to discuss at this point. Why do I want to chose this particular index at this time? Because right now it is flashing only its sixth sell signal since 1972, and I want my subscribers to understand what is happening in this area.

The 25-day plurality index is very simple and fundamental. First, we take the differential of the advances and declines on the NYSE each day. But we disregard whether those differentials are plus or minus. Thus, if 800 issues are up and 300 are down, our figure for the day is 500. Not plus or minus 500, just 500. Then we run a 25-day moving average of the daily differentials.

Here's the rationale for the index. During a major market decline, more and more volatility occurs on the downside. Near the bottom it is usual to see huge differential numbers in the advance-decline statistics such as 220 issues up and 1300 down. These big differentials mean the declines are swamping the advances, that panic is taking over, and as a rule the market is near a bottom area. When that happens, the 25-day plurality index tends to rise to 12,000 or more.

Conversely, when the market enters a top area there is generally a lot of churning as selling and buying move toward equilibrium. Often, at a major top, you will witness day after day in which advances and declines are very even, maybe 700 avances and 600 declines for a differential of 100. This will result in the 25-day plurality index dropping below 6,000.



I am indebted to Smith Barney for this valuable chart (left) showing the 25-day plurality index from 1978 to the present. Note that there have only been three previous instances during those eight years shown in which the 25-day plurality index dropped below 6,000. As you can see, the first sell signal resulted in a Dow drop of roughly 100 points, from the 900 area to the 800 area. The second sell signal took the Dow down 150 points from 903 to 740. The third sell signal

occurred in December 1983 and that signal saw the Dow drop from the mid-1200s down to 1086 in 1984.

For the record and going back in history, another 25-day plurality sell signal occurred in August 1976 with the Dow at 1000. The Dow held up until January 1977, then dropped to 742 in March of 1978. Going back even further, a sell signal on the plurality index appeared in December 1972 just prior to the 1973-74 bear market fiasco. So looking over the last 15 years, we have had FIVE previous signals on the plurality index, all of which were followed by varying degrees of market trouble. Now a sixth signal has appeared.

Does this mean trouble? I wish I knew for certain, but these sell signals are rare, and I thought this one was worth bringing to the attention of my subscribers. Let's hope that this is the sell signal that doesn't work.

INVESTMENT POSITION: The bull (a bit battered) remains in the box. The PTI keeps pushing to new highs, dragging the market (as if it were a 10-ton rock) up the Wall Street hill. And we continue to sit with our stocks and funds.

Stocks: You can manufacture electricity, but you can't manufacture WATER. The water companies are in a bull market now, and I like them. I like American Water Works (NYSE), Consumers Water Co. (OTC), California Water Service (OTC), Southwest Water Company (OTC) and San Jose Water Co. (NYSE). I believe a package of these five represent a good long term investment. The way things are going, water will be the scarcest commodity around within five to 10 years.

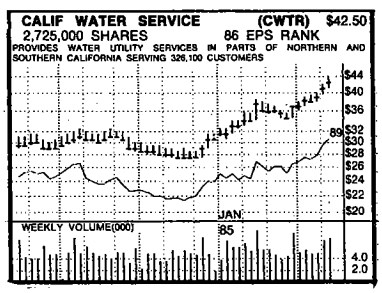
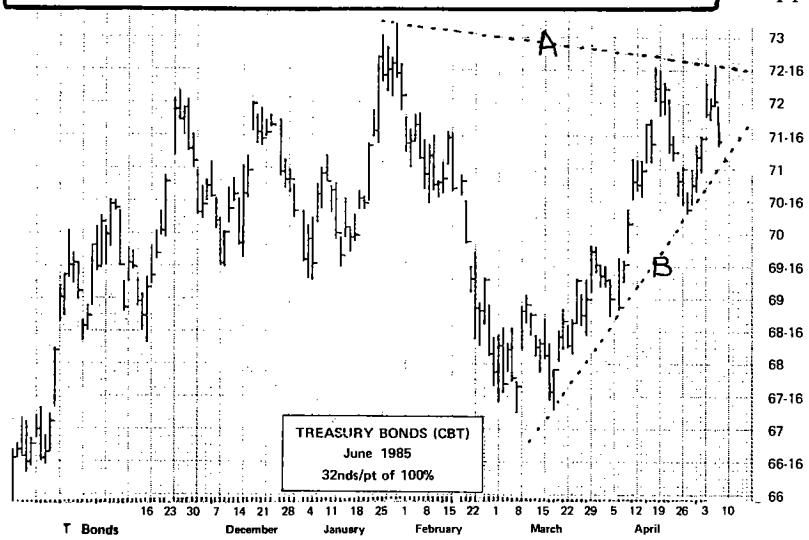


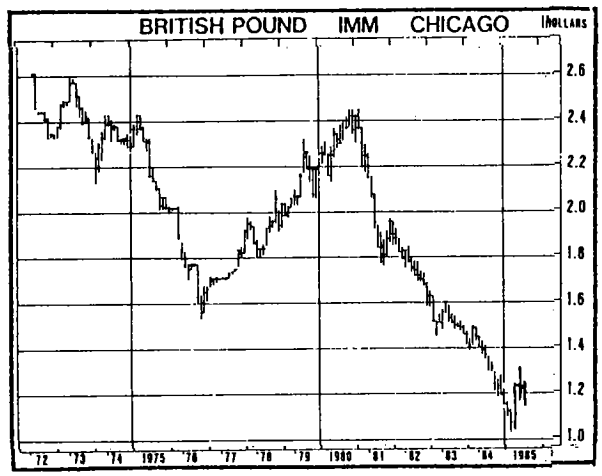
Chart courtesy of Investor's Daily newspaper



RATES: In the last Letter I stated that the new high in the June T-bill futures contract had not yet been confirmed by a new high in the June T-bond contract. Such action in the past has provided initial hints of a top in the bond market. And that's why the accompanying chart is important.

Trendline "A" on the chart defines the top of the T-bond move. Trendline "B" defines the bullish support. A rise in the June bond contract above 73 would represent an important breakout for the bonds -- and such action would be a prediction of lower long-term rates, a bullish situation for ALL of the markets.

Conversely, a break by the bonds below 70½ or certainly down to 70 would certainly suggest that the bonds were in the process of topping out. The bond picture, as this is written, is on the knife's edge. Sentiment is highly bullish toward bonds, everybody expects an upside breakout -- but I (noting the still-rising deficits) want to see it happen. Russell, you're a cynic! P.S. I'm still holding my bonds.



THE BUCK: It's been a good rally in the foreign currencies and a good drop in the dollar. But don't get carried away with the dollar's new weakness. Strongest of the currencies has been the British pound. This weekly chart (courtesy CRB) shows the rally in the pound--in perspective. Put it this way, it's been a nice rally, hardly impressive in the light of the pound's weakness since 1980. If the dollar has topped out, then it's got a long way to go before it shows on the weekly and monthly charts. Conclusion: It's mighty hard to draw conclusions from a few months of upside action, following a great bear market. My opinion--50/50 that the dollar has topped out on a long-term basis.

ACTING: In all my years of studying people and how they function, I believe one of the least understood area is that of thinking vs. action. Sigmund Freud knew a great deal about this area, and he proved it when he wrote, "Denken ist prober arbeit." Translated, this means "Thinking is rehearsing."

In therapy as investing, people do a lot of thinking. A man goes to a psychoanalyst three times a week for five years. In those

five years he talks and talks and dreams about his problems. At the end of the five years he may be surprised to note that not much has changed. Why has so little changed? Simple, thinking doesn't change anything (with the possible exception of the way you think). No, change is brought about not by thinking (rehearsing) but by ACTION.

For instance, I thought about quitting smoking for 18 years. I thought about my being hooked, I thought about how bad it was for me, I thought about getting lung cancer, I thought about burning holes in my shirts. It was unbelievably depressing. Finally, in 1971 I stopped rehearsing. I threw away my last pack of cigarettes, and I have never had a cigarette in my mouth since. My smoking dependency ceased when I stopped thinking and rehearsing, and when I finally took action.

Let me put it another way. NOTHING CHANGES BY ITSELF; you change your life by acting. But why are people so resistant to acting rather than thinking about acting? The reason is that the status quo feels SAFE while acting feels DANGEROUS. Nine out of ten people opt for the status quo in their lives. People in the slums are afraid to leave the slums, people who are workaholics are afraid to relax, people who over-eat are afraid to diet. A neurotic will give up anything as long as he can hang on to the one thing he treasures most--his neurosis!

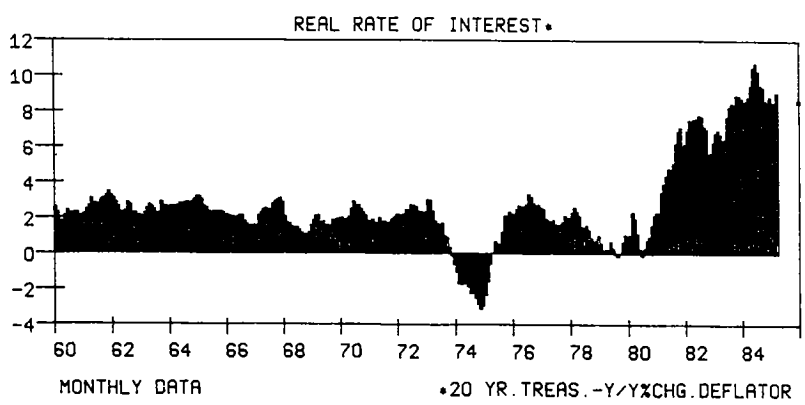
But the fact is that the status quo is usually a bore and is often unsafe. Think about it: the classic bore is usually the person who is totally comfortable where he is, and he will not even relate to anything different. The stuffed-shirt, upper class Englishman is the cartoon example of the ultimate bore. He wouldn't change a thing, even his tea time, if his life depended on it.

All right, what has all this got to do with investing and the market? The answer is, everything. How many times have you wished that insead of thinking about buying stock X (or selling it), you had actually acted, bought it or sold it? How many times have you cursed yourself because you saw some opportunity but instead of acting, you gave yourself ten reasons why it was better to sit tight and watch.

Successful people ALL have one thing in common--they are willing to act. Failures all have one thing in common, they think instead of acting. So if you've learned anything from this section, you can start by thinking about it. But if you are to actually benefit from this section, you'll have to comprehend the vast difference between thinking and rehearsing--and ACTING.

REAL RATES: Why, people ask me, have bonds been so strong? I tell them because they have offered such fat rates of return. The monstrous US deficits have done two things for investors of late: (1) they have pushed interest rates to very high levels; (2) they have squeezed inflation down towards the zero point. And the result has been the highest REAL rates of interest in modern history.

This chart at right illustrates my point. When the rate of inflation is subtracted from the yield on 20-year Treasury bonds, we get a picture that looks like this. And it's a picture of real interest rates in the 9% range.



A year ago I was telling my subscribers to buy municipal bonds and AA yields near 10%. Those bonds now look like bargains. The total return (interest and appreciation) has approached 20% in most cases, half of that return non-taxable. And so it goes. But relax, there will be new opportunities ahead. The markets, as the old saying goes, are always there.

NOO YAWK: The next Letter will be on time--but it will probably be abbreviated. Here's why. I'm going to spend a week in New York City (May 12 through 19). This will be my first full week vacation since I started Dow Theory Letters in 1958. Friends tell me that a full one-week vacation is a sign that I'm getting less neurotic. Harry Schultz has kidded me for years, saying that I break out in a cold sweat if I get outside of a 25-mile radius of La Jolla. Well you're wrong, Harry, so there! At any rate, the next Letter may be only four pages. Prepare yourselves, readers.

Many people wonder why I pick New York and what I do there. I pick the Apple because I spent the first 35 years of my life there, and although the City today is nothing like the place I grew up in, it's still my original home. The French have a saying that goes, "A man always returns to his first love." Maybe that's why I go back to the City every year. But yeah, things have changed. I remember, as a kid, hearing the newsboys yelling "Extry,extry!" almost every other night as they tried to push the evening papers--those were the days when NY had about six newspapers. I remember when ragged old men led horse-drawn carts round the City crying, "I cash clothes." They were offering to buy cast-off clothes. I remember when depression down-and-outers lived in huts made of crushed tin cans, right in Central Park. And I remember sitting in the DuPont boardroom on Saturday morning (yes, the NYSE used to open Saturdays) watching stocks go by at the rate of maybe 1.5 million shares a day.

What do I do in New York now? I do a lot of walking. I don't have any great urge to spend money in NY. I don't have any big urge to see shows, movies, night clubs. I do have an urge to kind of relive my youth by going up to Harlem to see "real" jazz, but I'm not sure I'd get out alive here in 1985 (it was no problem back in 1940 when I'd go up to Minton's on 116th St. and see jazz greats like Coleman Hawkins and Roy Eldridge all for the price (35¢) of a sloe gin fizz).

Now I go to SoHo and look at the art galleries or I walk down Madison and gaze at the fabulous stores or

I stroll down Columbus Avenue and marvel at how this former murky semi-slum has turned into a glitter street displaying the latest fashions and restaurants. As many veteran readers know, I have always been a restaurant nut, and I have always considered restaurants a branch of show business. So when in NYC I do try many of the best restaurants, and I lament that San Diego has nothing approaching them in style, skill or excitement. Oh yeah, I hit the museums. MOMA, Whitney, Morgan, Metropolitan and the up-town galleries. And I'll probably spend a full hour in Bloomingdales (after an hour I get dizzy). And somewhere along the line I'll sit at the fountain in front of the Plaza Hotel and just watch the people go by. To me, New York is the greatest walking and people-watching town in the world.

I'll have dinner or breakfast or lunch with a lot of old friends. And I'll invariably tell them that living is much better in California, that I can park my car in front of my office with no trouble, that I'm growing oranges and kumquats, tomatoes and lettuce in my backyard, and that, "It's a lot tougher to live in New York than it used to be back in the '40s and '50s". And they'll say, "Yeah, but when's the last time you had food like this?" And I'll admit that "the last time I had this kind of ambrosia and nectar was the last time I was in New York."

By the way, do you know anything about New York statistics? They're unique. There are 63,000 parking meters in NY, and despite this 10 million parking tickets were issued last year. Every day 800,000 cars enter NY while 10,000 traffic lights tell them what to do. NY has 4,000 buses, 230 miles of subway tracks, 3.5 million subway riders per day. The City had 17 million visitors last year. NY has 100 museums, 700 art galleries, 327 theatres, 25,000 restaurants, 908 undertakers on its 6,401 miles of streets. Ah yes, the City last year also had 88,000 auto thefts.

NOTES & QUOTES: Glamour: What's it all about? Warren Buffet, long a low-profile conservative millionaire, puts up $500 million to become an owner of ABC. Ted Turner (the mouth of the South) wants to take over CBS. Oil man Marvin Davis buys Twentieth Century Fox. John Kluge takes Metromedia private. Suddenly, everybody wants to be in the public's face, everyone wants power. The big boys come out of the shadows and want to head studios or broadcasting systems.

In my opinion, the communications industry is now selling at very fat prices. Consider this: John Kluge, who built Metromedia, took his company private while issuing $1.3 billion in junk bonds (that's right, $1.3 BILLION). Now Kluge has always been known as a very frugal man. So what happens? Marvin Davis (20th Century) and Australian communications king Rupert Murdoch go in and buy Metromedia from Kluge.

Murdoch-Davis will assume all of the $1.3 billion in debt and they will put up another $700 million on top of that. They will in turn sell Metro's Boston TV station for $450 million (Kluge paid $200 million for the station in 1982). So what do we have? Maybe a fourth network in the works -- and lots of debt. The price that Davis-Murdoch paid for the TV stations was about 17 times cash flow, even though 12 times cash flow in that industry is considered high. My prediction: Competition is going to heat up in the communications industry, and ultimately there's going to be mucho trouble, trouble via towering debt.

* *

Football: Can whitey still play football? You better believe it, but not like the blacks. Of the 28 first round picks in the 1985 NFL draft, 21 (I counted 'em) were black. What does it mean when the blacks, with around 15% of the US population, produce 75% of the first-round draft picks? (1) Football is a way for the best black athletes to make big money. (2) For whatever reason, blacks produce top athletes in far greater percentages than whites.

* *

Do you know where the horse capital of the Western World is? It's right here in San Diego. SD county has 25,000 horses, beating out Dallas, Phoenix and any of the counties of Kentucky. Del Mar (10 miles north of La Jolla) holds the "Wimbledon of horse shows" every year at its Del Mar National Horse show (takes place during the first 12 days of May). Why is SD the world's horse capital? Mild climate, year-round riding, low cost for up-keep because it's frost-free and still plenty of relatively cheap land.

* *

Question: Is America a world leader? Answer, yes, but maybe not exactly in the way we think we are. Note these paragraphs from an interview with award-winning journalist Stanley Karnow (from USA Today, April 16).

KARNOW: Thirty years ago, we thought we could do anything. The concept of the American century — which Henry Luce promoted at the beginning of World War II — began to fall apart in Vietnam, but also we began to see that the Japanese can make better cars than we can, that the Swedes have a better health care system, that the Arabs can cut off our oil. We realized that we're not a nation of John Waynes, that we can't dominate or influence everybody. I think that is a sign of maturity.

USA TODAY: Will the USA be able to influence the world?

KARNOW: When I travel around the world these days, the thing that's most astonishing is that the United States is held in higher esteem today than I've ever seen it. Every young person you see wants to come to America. It's cultural. When I was in Vietnam recently, they were playing rock music. The kids were all wearing blue jeans. God knows where they got them. Maybe they smuggled them in from Bangkok. They know what the prestige labels are, so they scratch them in pen on the back. Jordache! How the hell do they know that? It's astonishing! They think this is the land of opportunity; it's still true: There is gold in the streets in America. There is also the notion that this is a country with social justice, upward mobility, and it doesn't have a rigid class system. Those are the things we ought to be pushing. That's where our real influence is.

GOLD AND INFLATION: In the last Letter I noted that the halfway level of the most recent gold rally (284 to 339) was roughly 312. And since then gold has been fighting to hold above that significant halfway level.

Many people may believe that the price of gold has little to do with our lives. For instance, when asked about the 1985 rise in gold, Henry Wallich, one of the most influential members of the Federal Reserve Board, replied, "I think the price of gold frankly is detached from the economy but typically if the dollar goes down, the price of gold goes up." Would that it were that simple.

At the end of 1984, private assets in the US were over $22 trillion Of that total $12 trillion were financial assets (stocks, bonds, bank deposits) and $10 trillion were tangible assets (farm land, precious metals,

houses, box cars, jewelry, art treasures). During the 1970s there was a mass movement from financial assets to tangible assets and those who owned gold, stamps, paintings, real estate, etc. did very well indeed.

But here in the 1980s, we are seeing a switch from tangible assets to financial assets. Farm land, gold, silver, stamps, coins, a good deal of real estate has leveled off or moved down in value. If gold breaks below 284 (to a new low) then our best inflation/deflation barometer will be telling us that the value of $10 trillion in US assets will be declining. Despite what Mr. Wallich thinks, that would be no small thing, particularly when we have a $6 trillion total US debt load to support.

My own feeling (and I've expressed this many times) is that the careening debt load in the US is becoming increasingly difficult to carry. And the debt is also increasingly deflationary. Think about this: The Dow is currently about 25% above its 1966 peak level. This is equal to a compound growth rate (not including dividends) of less than 1% a year. How is that miserable performance possible? Simple: I believe the Dow has been discounting the negative effects of rising debt.

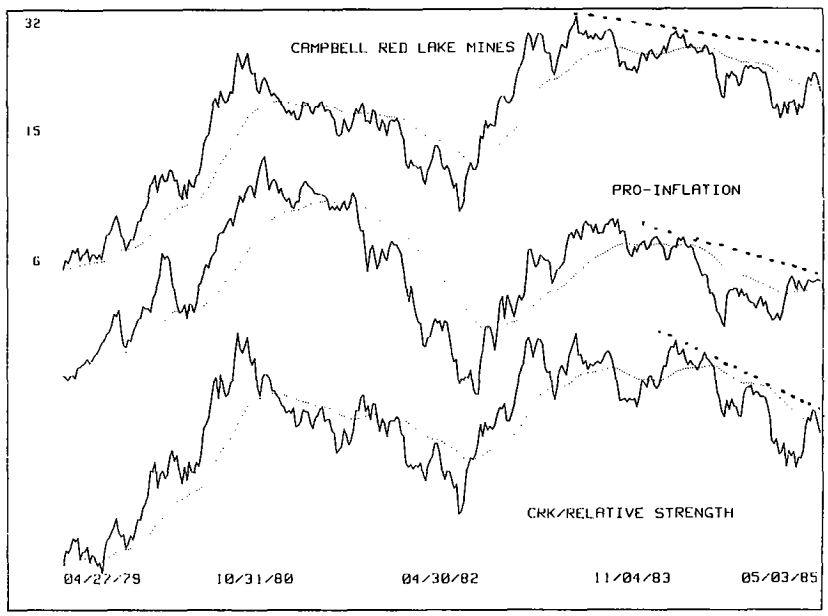
Again, why did gold climb to 850, then break under 300? In my opinion, the rise to 850 reflected the market's early belief that the rise in US debt was basically inflationary. In 1980 that view changed. The break in gold below 300 reflected the market's new-found belief that rising debt in the US is basically deflationary. To put it simply, in 1980 rising debt reached the point of no return. And the market's underlying perception of debt changed.

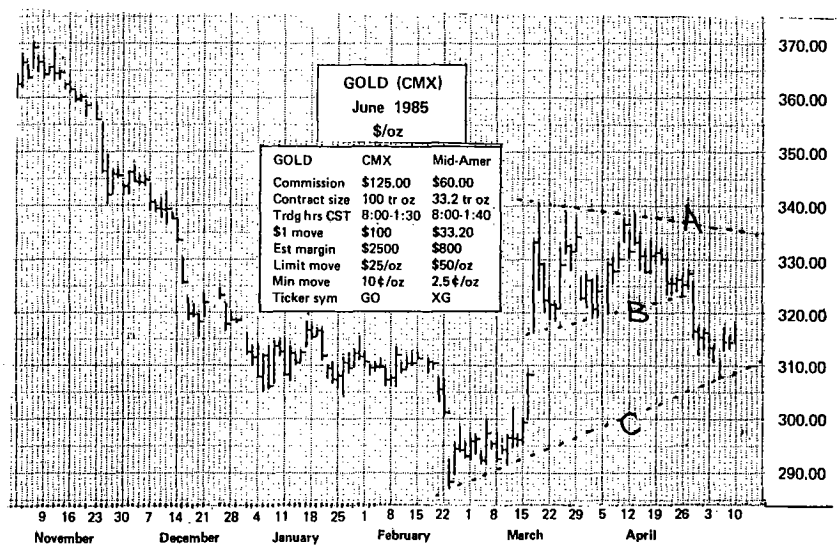
My good friend Robert Powers (president of Cycledata here in San Diego) was working with computers when most of us were still using abacus boards. Robert ran this chart off for me, and it's most interesting. The chart shows Campbell Red Lake, a pure gold stock listed on the NYSE. The top line shows the weekly action of CRK, and as you can see the intermediate trend is down. The center line shows Robert's pro-inflation stock group, that group of stocks that tends to rise with rising inflation. So far, we can say that this group is very mildly bullish for inflation. The third line shows the relative strength of CRK vs. the general market. Here we can say that CRK is definitely lagging the market.

Conclusion: The gold shares are not yet reflecting any real rise in inflation. The trend of CRK is still down, and the relative strength in CRK is still in a bear trend.

By the way, my own ratio of gold to common stocks (gold divided by the NYSE Composite) has again turned bearish, following a little upward blip. In other words, relative strength has now switched in favor of common stocks rather than gold. This has been confirmed, to some extent, by the strength in the bond market (bonds usually decline when inflation rears its head).

The bottom chart on this page is a daily chart of the June gold contract (chart courtesy of Dunn and Hargitt). If you remember, gold had formed a little triangle bordered by trendlines A and B. Then gold plunged below trendline B, filling the March gap in the pattern. I have now drawn a new rising trendline C. The question -- can June gold hold above trendline C or above 305? If it can, we can say that gold is in the process of building a bottom and that the February low is safe. But if 305 is hit -- then the gold picture will darken -- considerably.





LATE NOTES: "Never mind what Russell says, hopes tor or worries about, JUST FOLLOW HIS PTI." Maybe that's the ultimate secret of making money in the stock market. As readers know, the PTI has been rallying to high after high, and the market is finally following the PTI up. On May 10 both the S&P 500 and the NYSE Composite posted record highs,as the stock market finally put together two outstanding days. The bond market roared up as well. Clearly, the primary bull market is still very much intact on Wall Street.

NEXT MAILING: May 30